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SUBJECT: SCENE-SETTER FOR CAPSTONE FELLOWS

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SUMMARY  
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¶1. (SBU) Embassy Asuncion warmly welcomes CAPSTONE fellows February 22-24. President Fernando Lugo's administration represents an historic transition after the Colorado Party's 61 years of rule. Lugo's challenges are many: An inexperienced team, exceedingly high expectations for change, endemic corruption, weak institutions, and a divided Congress. Lugo must generate jobs and promote economic development while downsizing a bloated state and tackling social and security issues of key concern to his constituents. Lugo's top goals include fighting corruption, strengthening weak institutions, promoting economic growth, and improving health and education services. Your visit demonstrates broad U.S. interest in our bilateral relationship and support for the Paraguayan government at a critical moment in the country's history. END SUMMARY.

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THE POLITICAL REALITY  
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¶12. (SBU) President Lugo's administration represents the first interruption in Colorado Party rule in 61 years. A former Catholic bishop, Lugo won 40.8 percent of the vote in April 2008 national elections, handily beating out competitors in a 4-way race. His Patriotic Alliance for Change (APC), a loose coalition of political parties, won a large block of seats in Congress but does not have a majority. By voting overwhelmingly for change, the Paraguayan people gave Lugo a mandate for political, economic, and social reform. However, they also have high short-term expectations. Since his August 15 inauguration, Lugo has assembled a diverse team of politicians and technocrats to serve in his cabinet. Lugo's challenges are many, and he will have to overcome endemic corruption, weak institutions, and a divided, but antagonistic, Congress. A more in-depth discussion of some of Lugo's challenges follows.

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THE ECONOMIC REALITY  
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¶13. (SBU) Lugo must promote economic development while shrinking the bloated Paraguayan state. Agriculture represents 21.9 percent of gross domestic product (GDP), and the economy is heavily dependent on exports of soybeans, cotton, grains, cattle, timber, sugar, and electricity. More than 250,000 families (out of a national population of some 6

million) depend on subsistence farming activities and maintain marginal ties to the larger productive sector of the economy. Paraguay boasts vast hydroelectric resources, including the massive Itaipu hydroelectric dam built and operated jointly with Brazil, but fails to capitalize on those resources. The new government welcomes foreign investment, but widespread corruption and a weak judicial system are deterrents to investment. Paraguay's real GDP in 2007 was USD 12.8 billion (in 2000 dollars), with a per-capita GDP (purchasing power parity) of USD 4,000 in current U.S. dollar terms; inflation in 2007 was 6.0 percent, down from 12.5 percent in 2006. In addition to retail, banking, and professional services, there is significant commercial activity involving the import of goods from Asia and the United States for re-export to neighboring countries.

The underground economy, which is not included in the national accounts, probably equals the formal economy in size.

**¶4.** (SBU) Paraguay's plan to weather the global financial crisis seeks to create jobs and maintain a GDP growth rate of 2-3 percent in 2009. The first phase of the plan aims to ensure liquidity in the banking system and manage resources with bilateral and multilateral organizations. The second phase will focus on infrastructure priorities: construction, roadways, housing and waterworks, as well as expansion of conditional-cash transfer mechanisms for low-income families.

The third phase seeks to improve credit access for production sectors; the fourth phase aims to increase public and private spending. Phases 2 through 4 will require congressional approval.

**¶5.** (U) Bilateral trade with the United States has increased over the last six years even as there remains much untapped potential for growth. More than a dozen U.S. multinational firms have subsidiaries in Paraguay, and some 75 U.S. businesses have agents or representatives in Paraguay. Cargill, ADM, Coca Cola and Exxon-Mobil are the largest U.S. companies operating in Paraguay. The United States was the largest foreign investor in Paraguay, with USD 616.50 million, followed by Brazil with USD 230.85 million.

**¶6.** (U) Paraguay has inefficient state-owned monopolies in the rail, oil and gas, cement, steel, electricity, water, and telephone service industries. Political realities render outright privatizations of state-owned enterprises unlikely in the short term, although Lugo's economic team is discussing public-private partnerships to reform state-owned enterprises. The large state-run companies most attractive to foreign buyers (such as the telecom and electricity distribution companies) employ thousands and have served as outlets for political patronage.

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#### PUBLIC SECURITY AND SOCIAL ISSUES

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**¶7.** (SBU) Security and social issues are top concerns of Lugo's constituents. Violent crime is increasing in urban and rural areas, and the public generally believes that Paraguayan security forces (particularly the corrupt police) do not meet their security needs. The "landless" farmer movement has increasingly taken to protesting and invading, or illegally occupying large, privately-held ranches, in agitating for agrarian reform. On some occasions, protests and "land invasions" have resulted in deaths or injuries.

**¶8.** (SBU) The Tri-Border Area (TBA) of Paraguay, Argentina and Brazil is a hub for trans-national criminal activity including drug trafficking, trafficking in persons (TIP), arms trafficking, intellectual piracy, and money laundering. Paraguay is a major transshipment point for cocaine from Colombia and Bolivia to Brazil; it is the top marijuana producer in South America, and Paraguay remains a regional haven for money laundering. Paraguayan authorities experience difficulties enforcing the law because of hostile geography, corruption, chronic understaffing, and the political and judicial power some drug traffickers wield. Paraguay took a giant step forward on money laundering,

intellectual property violations, and trafficking in persons by passing a tougher penal code in 2008 that will go into effect this June.

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LUGO'S GOALS AND U.S. ASSISTANCE TO PARAGUAY  
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¶19. (U) Lugo's goals include strengthening democratic institutions, fighting corruption, promoting economic growth, and improving health and education services. Police and land reform, including a national land survey, are also priorities. Lugo and several key ministers have expressed interest in closer commercial ties with the United States, which the October 27, 2008 Bush-Lugo White House meeting reinforced.

¶10. (U) USG activities in Paraguay support Lugo's goals of strengthening democratic institutions, promoting sound economic policies and good governance, and disrupting criminal organizations. The USAID-administered USD 30.3 million Millennium Challenge Corporation's (MCC) Threshold Program Phase II (announced January 15) will support Lugo's anti-corruption efforts. (NOTE: Phase I of the MCC's Threshold Program provided USD 35 million over the past two years in an effort to fight corruption and formalize Paraguay's economy. END NOTE.) USAID/Paraguay's FY08 budget is USD 7.8 million and focuses on economic growth, health, the environment, and democracy. In October 2008, the USG announced an additional USD 10 million in assistance for health and economic development. USAID's Economic Growth Program ("Paraguay Vende") has generated over USD 60 million in sales and over 30,000 full-time job equivalents since 2003, thus supporting Lugo's goal to reduce poverty. Likewise, USAID's Health Program supports Lugo's interest in improving basic health services. By decentralizing health services, improving maternal and child care services, and increasing Paraguay's capacity to deliver family planning services. In the environment sector, USAID supports improved management of protected areas. The Democracy Program focuses on fighting corruption, giving civil society a voice, and promoting decentralization and municipal development.

¶11. (SBU) Post maintains bilateral assistance programs to combat narcotics trafficking, money laundering, intellectual property violations, and trafficking in persons. A Department of Justice Resident Legal Advisor and advisors from Treasury's Office of Technical Assistance work behind-the-scenes to assist the Paraguayan government. The Peace Corps has an active program in Paraguay. One of the Embassy's leading public diplomacy efforts is its English language scholarship program.

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THE MILITARY'S MISSION  
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¶12. (SBU) Paraguay's military is a small force struggling to redefine itself. The Army is the largest of the three services (6,000), followed by the Navy (2,000) and Air Force (1,200). The military's primary missions are to protect Paraguay's territorial integrity, defend the legitimate authorities in accordance with the constitution, and cooperate in civil defense. It does not play a leading role in counter-drug operations, although the military provides a specialized tactical unit to support the counternarcotics secretariat. The U.S. military's Special Operations Command is in the process of training and equipping a company-size Joint Immediate Response Detachment (DCEI), and the Presidential Guard Regiment has a specialized counter-terrorist platoon.

¶13. (U) Paraguay's military infrastructure and equipment are old, obsolete and in desperate need of repair or replacement. Ninety percent of the budget is used to pay salaries, and five percent is used for sustaining conscripts, leaving only five percent for operations, maintenance and training. Budget problems are not expected to go away in the near

future due to a lack of Congressional support and lingering memories of the Stroessner dictatorship. Despite these challenges and a record number of forced retirements of Colonels and Generals in November 2008, the military has remained subordinate to civilian authority under the leadership of new Military Forces Commander Admiral Cibar Benitez and President Lugo's Defense Minister Luis Bareiro Spaini (the latter of which is not in the military chain of command). When called, the military has supported law enforcement activities and public health campaigns, and provided transportation assistance for farmers to bring their products to market. The military is still seen as the first line of defense in a crisis, and many Paraguayans feel safer when the military is out on the streets.

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**Strong Record of Military Cooperation**  
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**¶14.** (U) USG support for the Paraguayan military is second only to our support for Colombia in South America. Our 505 Assurance Agreement enables us to assist in the deployment of a United Nations Global Peace Keeping Operations Unit (UNPKO). Paraguay is currently allocated USD 4.1 million in Global Peace Operations Initiative (GPOI) funds. These funds are being used to refurbish the Paraguayan Military Forces' Joint Peace Operations Training Center (CECOPAZ) physical plant; train a rotation of three company sized Multi-role Engineer Companies to deploy on UNPKO missions under Paraguayan flag; and increase their overall capacity to train officers and soldiers.

**¶15.** (U) Through our U.S. Special Forces, we provided Paraguay with some USD 3.8 million in 1208 funds allocated for weapons and other equipment to assist in developing Paraguay's Joint Immediate Response Detachment (DCEI). This effort has been critical to realizing strategic initiatives proposed through our Counter Terrorism Fellowship Program (CTFP), to deter illicit transnational activity and to include the designation and creation of a Paraguayan Tier 1 unit (equivalent to a National Mission Response Force). Despite the unit's successes, the GOP has shown some hesitation about how continued U.S. support for the unit should manifest itself after June 2008.

**¶16.** (U) Other security funding comes from the State Department's International Narcotics and Law Enforcement (INL), which along with DEA and U.S. Special Forces, assists Paraguay's National Anti-Drug Secretariat (SENAD) in combating narcotics trafficking. We also facilitate joint exercises relating to humanitarian assistance and disaster relief and work with the Military Forces Command and National Emergencies Secretariat to strengthen and improve the Paraguayan government's emergency response system. Paraguay also has a robust relationship with the Massachusetts National Guard (MANG) through the State Partnership Program and it has expressed interest in acquiring U.S. technical assistance to develop its National Security Strategy and National Defense Plan.

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**COMMENT**  
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**¶17.** (SBU) Your interest in Paraguay demonstrates broad U.S. interest in the bilateral relationship, and support for Paraguay's pragmatic president at a critical moment in the country's history. When meeting with Paraguayan interlocutors, you should encourage them to continue working with the USG to strengthen our bilateral relationship. You also should encourage Paraguay to continue its efforts to train and support its contingent of UN peacekeepers, and offer continued U.S. assistance via seminars, conferences, orientation visits, advisory and instructional activities for both Paraguay's Armed Forces and civilian institutions. END COMMENT.

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